

Internal Revenue Service

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Date: June 19, 2006

Legend:

X =

Trust 1 =

Trust 2 =

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

Y1 =

Y2 =

Dear :

This is in reply to a letter dated November 21, 2005, submitted on behalf of X, requesting relief under § 1362(f) of the Internal Revenue Code.

Facts

The information submitted states that X was incorporated on D1 and made an election to be an S corporation effective D1. On D2, shares of X were transferred to Trust 1 and Trust 2. From D2 until D3, Trust 1 and Trust 2 were permitted shareholders of an S corporation under § 1361(c)(2)(A)(i). Effective D3, the beneficiary of each of Trust 1 and Trust 2 elected to treat Trust 1 and Trust 2 each as a Qualified Subchapter S Trust (QSST).

It was intended that Trust 1 and Trust 2 each qualify as a QSST. However, for taxable years Y1 and Y2, the trustees of Trust 1 and Trust 2 failed to distribute income annually as required by § 1361(d)(3)(B). Therefore, X's election terminated on D4. Trust 1 and Trust 2 distributed the income for taxable year Y1 on D5 and for taxable year Y2 on D6. Trust 1, Trust 2, and the beneficiary of each trust represent that they will amend their returns consistent with Trust 1 and Trust 2 being QSSTs.

X represents that the circumstances resulting in the termination of X's S election were inadvertent and were not motivated by tax avoidance or retroactive tax planning. X and its shareholders consent to make any adjustments (consistent with the treatment of X as an S corporation) as may be required by the Secretary.

Law and Analysis

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under § 1362(a) is in effect.

Section 1361(b)(1) defines a "small business corporation" as a domestic corporation which is not an ineligible corporation which does not (A) have more than 100 shareholders, (B) have as a shareholder a person (other than an estate and other than a trust described in subsection (c)(2)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than 1 class of stock.

Section 1361(d)(1) provides that a QSST whose beneficiary makes an election under § 1361(d)(2) will be treated as a trust described in § 1361(c)(2)(A)(i) and the beneficiary of such trust shall be treated as the owner (for purposes of § 678(a)) of that portion of the QSST which consists of S corporation stock to which an election under § 1361(d)(2) applies. Section 1361(d)(2) provides that a beneficiary of a QSST may elect to have § 1361(d) apply. Under § 1361(d)(2)(D), this election will be effective up to 15 days and 2 months before the date of the election.

Section 1361(d)(3)(A) defines a QSST as a trust (A) the terms of which require that (i) during the life of the current income beneficiary, there shall be only one income beneficiary of the trust; (ii) any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary; (iii) the income interest of the current beneficiary in the trust shall terminate on the earlier of the beneficiary's death or the termination of the trust; and (iv) upon the termination of the trust during the life of the current income beneficiary, the trust shall distribute all of its assets to that beneficiary; and (B) all of the income (within the meaning of § 643(b)) of which is distributed (or required to be distributed) currently to one individual who is a citizen or resident of the United States.

Section 1361(d)(4)(B) provides that if any QSST ceases to meet any requirement of § 1361(d)(3)(B) but continues to meet the requirements of § 1361(d)(3)(A), the provisions of § 1361(d) shall not apply to such trust as of the first day of the first taxable year beginning after the first taxable year for which it failed to meet the requirements of § 1361(d)(3)(B).

Section 1362(d)(2) provides that an election under § 1362(a) shall be terminated whenever (at any time on or after the first day of the taxable year for which a corporation is an S corporation) such corporation ceases to be a small business corporation. A termination of an S corporation election under § 1362(d)(2) is effective on and after the date of cessation.

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d), (2) the Secretary determines that the circumstances resulting in the termination were inadvertent, (3) no later than a reasonable period of time after the discovery of the circumstances resulting in the termination, steps were taken so that the corporation is a small business corporation, and (4) the corporation, and each person who was a shareholder of the corporation at any time during the period of inadvertent termination of the S election, agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in the termination, the corporation is treated as an S corporation during the period specified by the Secretary.

Conclusion

Based solely on the facts submitted and the representations made, we conclude that X's election to be treated as an S corporation terminated on D4. We also conclude that the termination was an inadvertent termination within the meaning of § 1362(f). Accordingly, under the provisions of § 1362(f), X will be treated as continuing to be an S corporation from D4, and thereafter, provided that X's S corporation election was valid and was not otherwise terminated under § 1362(d). X's shareholders, in determining their respective income tax liabilities during the termination period and thereafter, must

include their pro rata share of the separately stated computed items of income or loss of X, as provided in § 1366, make any adjustments to basis provided in § 1367, and take into account any distributions made by X as provided in § 1368.

Additionally, from D4 and thereafter, Trust 1 and Trust 2 will be treated as QSSTs described in § 1361(d)(3) (assuming that they otherwise qualify as QSSTs). Trust 1, Trust 2, and each trust's beneficiary must file amended returns. If X, its shareholders, including Trust 1 and Trust 2, fail to treat X as described above, this ruling shall be null and void.

Except as specifically provide herein, no opinion is expressed or implied as to the federal tax consequences of the facts described above under any other provision of the Code. In particular, no opinion is expressed as to whether X is otherwise eligible to be an S corporation or whether Trust 1 and Trust 2 are eligible QSSTs under § 1361(e).

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Under a power of attorney on file in this office, a copy of this letter will be sent to X's authorized representative.

Sincerely,

Audrey W. Ellis
Senior Counsel, Branch 1
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)

Copy of this letter

Copy for § 6110 purposes

cc: